# the hidden welfare system revisited

a report by the
national council of welfare
on the growth in tax expenditures

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national council
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# T H E   H I D D E N   W E L F A R E   S Y S T E M
# R E V I S I T E D

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National Council of Welfare
on the Growth in Tax Expenditures

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# INTRODUCTION

The growth of the federal government's deficit over the past six years has been the subject of mounting public concern. From slightly under $1 billion in the 1973-74 fiscal year, the difference between federal expenditures and revenues increased to more than $10 billion in 1977-78, and is expected to reach $12 billion in the current fiscal year.

The reasons for these unprecedented deficits are complex, and largely rooted in the general weakness of the economy and its effects on government revenues and expenditures. Public debate, however, has singled out one aspect of the problem for particular blame. Not surprisingly it is the part which is both the most visible and, seemingly, the easiest to understand: the size of government spending. From all quarters there have been ever more insistent demands that governments cut back on expenditures.

These demands have not gone unheeded. Beginning with the $1.5 billion in cuts announced just before Christmas 1975, the federal government has made several well-publicized attempts to limit its spending, the most recent being last summer's announcement that $2.5 billion would be slashed from planned expenditures.

Yet at the same time as so much attention has been given to direct spending by government, no attention has been paid to another set of schemes which are every bit as responsible for the deficit. Many of these are programs of questionable merit whose effectiveness or continuing need are never evaluated. But their revenue effects are never even reported, and their often dramatic year-to-year increases are completely ignored. They are the multi-billion-dollar programs which are contained in the income tax system: the more than 60 deductions, exemptions, credits, exclusions and preferential tax rates which make up Canada's invisible tax expenditure budget.

In terms of the bottom line of the balance sheet, it makes no difference whether the government spends an extra dollar directly or gives someone an extra dollar in tax breaks through a tax expenditure. In either case the gap between expenditures and revenues - the deficit - has grown by a dollar. To discuss the deficit but to ignore tax expenditures makes as much sense as setting out to discuss direct spending but pretending that half the government departments don't exist.

The cost of tax expenditures - the revenue loss which results from them - and the increase in those costs from year to year are considerable. Between 1975 and 1976, for example, (the most recent years for which tax data is available) the federal government, as a result of its first bout of spending cutbacks, kept the increase in its direct expenditures to 10.4%. However the tax loss due to 20 exemptions, deductions and credits in the personal income tax system[1] (all of those for which enough data is published that costs can be estimated) went up by 17.9%. Some tax expenditure items increased by as much as 70%.

The federal deficit for the 1976-77 fiscal year came to $6.3 billion. The tax loss in 1976 due to the 20 tax expenditure provisions came to $7.1 billion[2] - eight hundred million dollars more. The federal deficit for the year was as much the fault of tax spending as of direct spending.[3] And, it should be stressed, we have only been able to estimate the cost of 20 out of more than 60 tax expenditures.[4] It is not unreasonable to expect that the full cost of tax expenditures may well be double this $7.1 billion.[5]

The purpose of this paper is to investigate some of the causes and distributional effects of tax expenditure increases. We begin by examining the concept of a tax expenditure which the National Council of Welfare first explored in its 1976 report The Hidden Welfare System. Then we will look at various tax

expenditure provisions in the personal income tax system during the three-year period from 1974 (which was the basis for The Hidden Welfare System) to 1976. Our intent is to identify by how much tax spending increased, why it increased, and which income groups benefitted.

## SPENDING AND THE INCOME TAX ACT

Most people think of the Income Tax Act only in terms of collecting money for the government. Of course included among the Act's many sections are all those provisions which are essential to the operation of the tax system as a means of raising revenue. Besides setting out the rates of taxation, these provisions also specify the period of time over which income should be measured; who is required to file a tax return; the procedures for reporting and paying the tax; and the amounts that may be deducted for expenses related to earning the income.[6] Taken together, these provisions define the basic or 'normal' tax system - Parliament's judgment as to the 'fair share' of income tax which should be borne by each individual on the basis of his or her ability to pay.

There is, however, another set of provisions in the Act. In contrast to the first group, these sections bear no relation to the tax system proper and are unnecessary for its fair and efficient operation as a means of raising revenue. They were put in the Act not because they are needed for a technical measurement of income, but to give certain people a tax break - more specifically, to provide financial assistance to certain groups and individuals, and to reward certain forms of economic behaviour. These provisions allow their beneficiaries to pay less tax than the 'fair share' which the basic tax system would require. It is this revenue loss which leads to tax expenditures.

Just because the Tax Act disguises its spending as tax reductions, no one should be deceived into thinking that tax expenditures are anything other than real spending - every bit as real, in fact, as the $53 billion in direct spending which attracts so much attention. The government could replace all the tax expenditures in the Income Tax Act with direct spending programs that gave

grants of equivalent amounts to each of the people who now benefit from tax subsidies. From the point of view of the beneficiaries nothing would have changed financially, nor would there be any difference in terms of the net effect on the government treasury. Yet the new programs would be universally described as true government spending. So also are tax expenditures true spending.

The items that make up the tax expenditure budget cover a range of activities as broad as that of the entirety of government itself. They include grants to industry and to prospective homeowners, encouragement to save for retirement and to invest in Canada, assistance to the aged and aid to farmers, and much else.

The objectives of most tax expenditures - like the objectives of most direct spending programs - are ones that seem worthy of public support. Few would argue that it is not a good thing to help the aged, to encourage more investment by Canadians in their own country, and the rest. The problem, however, lies in the way in which tax expenditures carry out these objectives.

Tax expenditures operate with no officially published estimate of their cost, no public evaluation of the degree to which they are accomplishing their objectives, and no information on whom they are benefitting. When their costs escalate dramatically, either because a provision of the Act has been made more generous or because more taxpayers have suddenly taken advantage of a subsidy, the cost increase goes unseen. There can't be a public outcry about an increase that the public doesn't know about; nor can there be a rational evaluation of whether the money could be better spent for some other purpose.

When a tax expenditure fails to accomplish its objective, or has an effect which was not at all planned, there is no way for this to be known and debated. Millions of dollars in tax revenues are just lost - a windfall to those fortunate enough to be able to

take advantage of the provision, but a waste to the country at large which receives little or none of the social or economic benefits for which the scheme was supposedly designed.

And, since most tax subsidies operate through exemptions and deductions, tax expenditures almost inevitably give their greatest rewards to those with the highest incomes, and none at all to those with the lowest. This is the unavoidable consequence of deductions in a progressive tax system. If $100 is exempt from tax, the saving to an individual (and the expenditure for government) is $60 for a high-income person in a 60% tax bracket, $25 for a moderate-income worker in a 25% bracket, and zero for a person poor enough to be below the tax-paying threshold. Tax expenditures are equity in reverse.

The table on the following page divides taxfilers into ten equal-sized groups (or deciles) according to their incomes; the first decile includes the 10% of taxfilers with the lowest incomes, the second decile the next 10% with slightly higher incomes, and so on to the tenth decile which includes the 10% with the highest incomes. For each group the table shows the average tax saving in 1976 from the 20 exemptions, deductions and credit and the group's percentage share of the 1976 expenditure of $7.1 billion for these 20 tax provisions.

| Decile | 1976 average tax saving | % of 1976 tax expenditure |
|---|---|---|
| 1st | $ 0 | 0% |
| 2nd | 59.57 | 1.0 |
| 3rd | 179.23 | 3.1 |
| 4th | 312.29 | 5.4 |
| 5th | 372.09 | 6.5 |
| 6th | 445.93 | 7.8 |
| 7th | 570.15 | 10.0 |
| 8th | 735.57 | 12.8 |
| 9th | 992.04 | 17.3 |
| 10th | 2,068.40 | 36.1 |

Of the $7.1 billion spent in 1976, 53% went to the highest-income 20% of taxfilers. While a median-income taxfiler saved $400 in that year because of the 20 tax expenditure provisions, the highest-income 5% of taxfilers averaged savings of $2,662 - more than six times as much. (For the 77,400 taxfilers with incomes over $50,000, it might be noted, the tax saving was $4,781, twelve times that of the person in the middle.) Of the $1.8 billion increase in tax expenditures between 1974 and 1976, only $1 out of every $10 went to the lower-income half of taxfilers; $4 of every $10 found their way into the pockets of the top 10%.

## INCOME TAX AND INCOME SECURITY

Few parts of government's direct spending are so often the target of demands for cost restraint as income security programs. The spectres of runaway unemployment insurance rolls and rampant welfare abuse, even when they aren't explicitly invoked, still lurk behind many of the calls to "do something about spending". It seems to make little difference that unemployment insurance costs what it does because of the extraordinary level of joblessness of the last two years, or that little abuse of welfare has ever been found in spite of stringent policing by provincial departments. Nor does it seem to matter much that the largest direct expenditures in this field are for the pension programs which provide an essential income to hundreds of thousands of Canada's aged. Somehow, somewhere - it is repeatedly asserted - millions of dollars can be saved.

Indeed there are millions that might be 'saved' in income security programs, even billions. But unless Canadians want to inflict tremendous suffering on the aged, the disabled, the unemployed and single-parent families, little of this money is to be found in the budgets of direct spending programs. Instead, the place to look is in the income security provisions of the Income Tax Act.

The three most commonly used of these provisions reduce income subject to tax according to the number of persons who are dependent on the income. They are the exemption for a spouse (called the 'married or equivalent' exemption since in single-parent families it applies to the oldest child), the exemption for dependent children, and the exemption for other eligible dependents (usually grandchildren, nephews or nieces being supported by a taxpayer).[7] All these exemptions are indexed (their 1979 amounts are

$2,320 for the married exemption, $500 for a dependent aged under 17, and $910 for a dependent aged 17 or over), and they are available only if the spouse or dependent has little or no income of his/her own.

Another set of income security provisions of the Tax Act reduces the taxable income of certain individuals who, in the opinion of Parliament, are deserving of special consideration.[8] These include the age exemption allowed to anyone 65 or over, and the disability deduction allowed to the totally blind and those confined to a bed or wheelchair for 12 months or more. Both of these provisions are also indexed and for 1979 have been set at $1,660. Some of the elderly benefit further from the pension income deduction, introduced in the 1975 tax year, which allows the exempting of $1,000 in retirement income derived from private pension plans.

The final group of income security programs in the Income Tax Act are the provisions allowing the deduction of contributions to public and private plans which provide a substitute for earnings lost because of unemployment or retirement. These are the deductions for Canada/Quebec Pension Plan contributions, Unemployment Insurance premiums, and contributions to company or union pension plans (what are called Registered Pension Plans) and to Registered Retirement Savings Plans.

The table on the following page shows the tax loss (in millions of dollars) to the federal and provincial governments in 1974, 1975 and 1976 resulting from each of these exemptions and deductions. The figures which follow the 1975 and 1976 dollar amounts show the percentage increase in each expenditure from the preceding year.

| | 1974 | 1975 | | 1976 | |
|---|---|---|---|---|---|
| | [Dollar figures are in millions] | | | | |
| Married or Equivalent | $1,324 | $1,415 | 7% | $1,547 | 9% |
| Dependent Children | 808 | 869 | 8 | 966 | 11 |
| Other Dependents | 41 | 40 | -2 | 46 | 15 |
| Aged and Disabled[9] | 294 | 300 | 2 | 314 | 5 |
| Pension Income | -- | 146 | - | 171 | 18 |
| Canada/Quebec Pension Plans | 249 | 288 | 16 | 332 | 16 |
| Unemployment Insurance | 204 | 245 | 20 | 325 | 33 |
| Registered Pension Plans | 467 | 561 | 20 | 707 | 26 |
| Registered Retirement Savings Plans | 513 | 613 | 19 | 859 | 40 |

All together, spending in 1976 on the income security programs of the Income Tax Act came to $5.3 billion. This was equivalent to 45% of what the federal government spent in total during the 1976-77 fiscal year on family allowances, pensions for the aged, Unemployment Insurance payments, Canada Pension Plan benefits, and contributions to the provinces for the cost-sharing of provincial welfare schemes under the Canada Assistance Plan.

In every instance in which there were direct expenditure programs comparable to tax expenditure schemes, the rate of increase in direct spending was less than that for tax spending. There was

indeed some truth in the charges of runaway welfare costs. Only the costs that were running away weren't the payments to the poor. They were the ones hidden in the tax system.

Family allowances, for example, saw a spending increase of only 9% between 1974 and 1976. This was largely the result of the government's decision to suspend the indexing of allowances for 1976, thus freezing the payments at their 1975 level. Those most hurt by this suspension, of course, were the poor since they retain the full amount of the allowance, while those with higher incomes return a portion to the treasury as a result of it being subject to tax. Moreover, the loss of even a few dollars a month has a far greater proportional impact on someone with a low income than on someone with a high income.

The tax expenditure equivalent of family allowances - the exemption for dependent children - saw no similar suspension of indexation, however. Thus between 1974 and 1976 the tax expenditure increased by 20% - more than double the rate of increase of family allowances. And since exemptions bestow the greatest benefits on those with highest incomes, the big winners from the 20% increase were those at the top of the income scale. The highest-income 10% of taxfilers received 39% of the $158 million increase in outlays on the dependent children's exemption.

In the period from 1974 to 1976 Unemployment Insurance was the subject of almost constant criticism. The 47% increase in the cost of U.I. benefits was characterized as a scandal demanding immediate government action. Not so, however, the 59% increase in the Unemployment Insurance tax expenditure. No one knew about it so no one complained.

The $325 million revenue loss in 1976 resulting from the deductability of Unemployment Insurance premiums amounted to 31% of the total collected by the U.I. payroll tax from employees in

that year. The equitable way of distributing this $325 million would have been to give each U.I. contributor a refund of 31% of his contributions. By using a deduction, however, there was no such equitable refund. A person in the highest tax bracket (where the marginal rate was 62%) received a rebate of almost two-thirds of his or her premiums. A low-income person below the tax-paying threshold got a rebate of nothing.[10]

Spending on pensions for the aged - the Old Age Security, Guaranteed Income Supplement, and, starting in 1975, the Spouse's Allowance programs - increased by 29% between 1974 and 1976. Because of the low incomes of the large majority of Canada's elderly, combined with the fact that the Guaranteed Income Supplement and Spouses Allowance are income-tested, much of this increase went to persons in need.

In contrast, spending on the comparable tax expenditures - the age exemption and the four pension deductions - went up by 56% between 1974 and 1976 - twice as much. The biggest beneficiaries were those who were not in need. For example, while the lowest-income 50% of the aged received a tax saving, on average, in 1976 of $102.15 from the age exemption, the highest-income 5% saved an average of $567.01 - five and a half times as much. Of the $20 million increase in the expenditure for this exemption from 1974 to 1976, 48% went to those among the top 10% of taxfilers.

Of all the income security provisions of the tax system, however, none more clearly illustrates the runaway costs of tax subsidies or who benefits from the growth of the hidden welfare system than Registered Retirement Savings Plans (RRSPs). Under the terms of the Income Tax Act, contributions to such plans, and the interest earned on those contributions, are exempt from tax as long as the money remains in an RRSP. Annual contributions are limited to 20% of earnings, to a maximum of $3,500 a year for a

person who also contributes to a company or union pension plan, and $5,500 for a person who doesn't.

On the surface, RRSPs may seem reasonable. They encourage saving for retirement and, their defenders argue, really just defer tax (since the tax saved on the deduction is supposedly only postponed until after retirement when tax is collected on the income which the contributions made possible).

Closer inspection, however, shows that these rationales make little sense in terms of either equity or efficiency. In the first place, few people are in the same marginal tax bracket after retirement as during their working years; most are in lower brackets. The tax loss due to the deduction, therefore, is not fully recovered. Moreover, the combination of deductions with the 20%-of-earnings limit on contributions (so that low and moderate-income workers can't even shelter the same amount as the rich) means that the tax savings are overwhelmingly skewed in favor of the wealthy. In fact, the annual tax benefits to a person in the highest tax bracket can be as large as a low-income pensioner is expected to live on for a year from the combined Old Age Security and Guaranteed Income Supplement payments.

The table on the following page shows the average tax saving per contributor and the percentage of the total benefits from the RRSP tax expenditure in 1976 by income group. Taxfilers are again divided into tenths, or deciles, but the first five deciles have been combined into one category since there are so few RRSP contributors among them.

| Income Group | Average tax saving from RRSPs in 1976 | % of 1976 RRSP tax expenditure |
|---|---|---|
| Bottom 50% | $ 148.47 | 1.8% |
| 6th decile | 233.95 | 2.5 |
| 7th decile | 298.66 | 4.6 |
| 8th decile | 355.28 | 7.5 |
| 9th decile | 467.02 | 14.8 |
| 10th decile | 1,168.84 | 69.0 |

The extreme concentration of benefits at the top of the income scale is dramatic. Almost $7 out of every $10 went to the highest-income 10% of taxfilers and, in fact, more than half the benefits went to the top 5%. While RRSP contributors who were among the lowest-income 50% of taxfilers celebrated their $148.47 average tax saving, contributors who were among the top 5% enjoyed the comfort of $1,449.13 in savings - ten times as much.

As the table on page 10 shows, the Registered Retirement Savings Plan expenditure is the fastest growing of all the income security provisions of the Tax Act. After a hike of 19% between 1974 and 1975 (due primarily to the increasing number of persons who took advantage of the provision), the 1976 increase measured an astonishing 40%.

This 1976 increase was largely the result of provisions in the May 1976 federal budget which very substantially raised the maximum contributions allowed to higher-income taxpayers. While contributions were limited in both years to 20% of earnings, the 1975 maximum of $2,500 a year for persons already contributing to a company or union pension plan was increased for 1976 to the present level of $3,500, while the previous $4,000 maximum on other RRSP

contributors was brought up to $5,500. The only persons who could benefit fully from the RRSP change, it should be noted, were those earning over $27,500 (and their additional tax saving could be very substantial - for a person in the highest tax bracket, up to $1,000).

Sixty-two percent of the 1974-1976 increase of $346 million in benefits from the RRSP tax expenditure went to the 10% of taxfilers with the highest incomes; 43% went to the top 5% alone. Among all taxfilers, 10.5% made RRSP contributions in 1976; among the highest-income 5% of taxfilers, 50.6% made such contributions.

## ECONOMIC INCENTIVES AND TAX REWARDS

One of the basic jobs of government is to encourage activities which strengthen the economy and contribute to the economic well-being of society. Whether the specific goal is to get more housing built, or to create more jobs or to find new supplies of gas and oil, the results touch almost every aspect of our lives.

There are two ways that government can affect economic behaviour (other than passing a law ordering that something be done). It can pay individuals or corporations a direct cash reward for doing the desired thing, or it can give an indirect reward through a tax break. Of the two, the one most often favored is the tax route.

The Canadian income tax system is replete with 'economic incentive' provisions. There are tax breaks, for example, for making films in Canada, for drilling for oil, for building apartment houses, for investing in stocks and for installing pollution-control equipment in factories. The list goes on and on. Some of these tax breaks 'work' - at least to the extent that they seem to encourage what they were meant to encourage (which isn't to say that they necessarily do so in the most efficient way possible). Others are very questionable as to their effectiveness. Some simply reward companies and individuals for doing what they would have done even if there wasn't an incentive.

The reasons for government's preference for tax incentives instead of direct grants are clear. Not only can billions of dollars be spent invisibly with no public reporting required, but vast amounts of money can be put into projects which might be the cause of much controversy (and sometimes considerable embarrassment)

if they were funded openly. One could imagine, for example, the awkwardness of explaining the expenditure of hundreds of thousands of dollars of the public's money on a movie that flopped. Moreover, the beneficiaries of the tax rewards are almost always corporations or the wealthiest of individuals - hardly those whom the public would consider worthy recipients of such extensive government largesse.

Theoretically, of course, all of the economic incentive provisions of the Tax Act are available to everyone. Practically speaking, though, there might as well be a 'rich-only-need-apply' rule. Who else, for example, would be likely to have enough cash to invest in an apartment building or to underwrite a film?

However, there are three economic incentive provisions from which substantial numbers of non-wealthy taxpayers do benefit. The fact that these provisions bestow at least a part of their savings on people who aren't in the top few percent of the income range makes them atypical of the larger group of economic incentive measures in the tax system. Yet it is useful to examine them because they are well known and because the details of their costs can be calculated. They are Registered Home Ownership Savings Plans, the dividend tax credit, and the interest and dividend deduction.[11]

Registered Home Ownership Savings Plans (RHOSPs) are meant to induce Canadians to save towards buying a home. This provision of the Income Tax Act, introduced in 1974, allows the deduction from income otherwise taxable of up to $1,000 a year (to a lifetime maximum of $10,000) provided the money is put into a special account and eventually used to buy a house. RHOSPs are only available to persons who have never owned a home. The dividend tax credit is intended to encourage investment in Canada by reducing the tax on dividends paid by Canadian corporations.[12] The interest and dividend deduction is also meant to encourage domestic investment, as well as savings, by exempting from tax the first $1,000 in Canadian

bank and bond interest, stock dividends and the taxable portion of capital gains realized from Canadian sources (the inclusion of the latter began only in the 1977 tax year).

The following table shows the tax loss due to the two deductions and the credit[13] in 1974 through 1976, and the percentage increase in each tax expenditure from the previous year:

| | 1974 | 1975 | | 1976 | |
|---|---|---|---|---|---|
| | [Dollar figures are in millions] | | | | |
| RHOSP | $ 65 | $117 | 78% | $156 | 34% |
| Interest and Dividend Deduction | 546 | 664 | 22 | 721 | 9 |
| Dividend Tax Credit | 93 | 106 | 14 | 111 | 5 |

The most spectacular increase in any of the 20 tax expenditures for which we have been able to estimate the revenue loss was for Registered Home Ownership Savings Plans. The cost of this provision jumped by almost 80% between 1974 and 1975, and went up by another third in 1976. In a two-year period the tax spending on RHOSPs increased by two and a half times.

A large part of the 1975 RHOSP increase can be explained by the fact that, although the provision took effect for the 1974 tax year, the enabling legislation was not approved by Parliament until the early months of 1975. Many people, as a result, were not aware they could benefit from RHOSPs for the 1974 tax year. However they found out about the provision during 1975 and, as the figures show, many took advantage of it. While only 1.8% of taxfilers had RHOSPs in 1974, 3.2% - almost double - had such plans in 1975.

The smaller, but still very substantial, increase in expenditures for 1976 reflects the continued growth in public awareness of this tax shelter. This was spurred by the major advertising campaigns of trust and mortgage companies which encouraged the opening of RHOSP accounts. As well, more persons became aware of a loophole in the legislation (since closed) which allowed married couples to take advantage of the tax savings, even though they were already homeowners, through 'paper transfers' of the title to the home between the spouses. In 1976 the take-up rate for RHOSPs (the percentage of taxfilers who took advantage of the provision) went up to 4.2%.

This 4.2% take-up rate, however, was not uniform across all income groups. Among taxfilers with low incomes (under $5,000), it averaged about one-half of one percent. As income rose, so did the take-up rate, levelling off at about 7% for persons with incomes between $10,000 and $50,000. At incomes above $50,000, however, a curious thing happened: the take-up rate suddenly increased to 10%. RHOSPs, it would seem, have the most effect among the wealthiest of Canadians in terms of encouraging savings for a home. And, while the average RHOSP contributor saved $302 in 1976 from his or her contribution, those in the over-$50,000 income group saved $568.

In comparison to the increase in the RHOSP tax expenditure, the dividend tax credit and the interest and dividend deduction almost seem like slow growers, with rates of increase between 1974 and 1976 of 'only' 19% and 32% respectively. In both cases, as the table shows, the increase for 1976 was far smaller than that for 1975 - a consequence of the weakened state of the economy which affected the amount of dividends that companies paid their shareholders

There was, nonetheless, a jump of 22% in the interest and dividend tax expenditure between 1974 and 1975. This was due to the fact that in 1974 only interest was allowed as a deduction;

dividends were not added until the 1975 tax year. As well, the deduction began in the 1974 tax year, so an increase in cost could be expected in the subsequent year as persons rearranged their financial affairs to ensure they would have as much of the 'right' kind of income as possible. Needless to say, those in a position to do so would almost always be higher-income persons. Of the $118 million in increased outlays between 1974 and 1975, 53% went to the highest-income 10% of taxfilers; 35% of the additional benefits went to the top 5% of taxfilers alone.

This 35% figure, dramatic though it is, is small in comparison to what these 5% of taxfilers would receive if a recent proposal for a new 'economic incentive' tax expenditure is implemented - the proposal to exclude from tax the capital gains on the sale of shares in Canadian-owned companies. Almost all the benefits from such a scheme - an estimated $50 million a year[14] - would go to those at the top of the income scale. The reason is simple enough: those at the top realize virtually all the capital gains from stock transactions (and already receive huge tax benefits since half the profits from these sales are tax-free under the existing law). In 1976, the highest-income 1% of taxfilers received 99% of all the net gains from the sale of stocks.[15] They would get the same proportion of the benefits from any scheme that exempted these gains from tax.

The proposal to exclude capital gains is a good example of how the hidden welfare system thrives and grows, and is able to guarantee its large benefits to a few, by offering the possibility of small benefits to many. Substantial numbers of Canadians are shareholders. Most, however, have very small holdings, and they rarely sell their stocks.[16] Thus it is quite unusual for them to pay any capital gains tax at all. (In addition, since the dividend and interest deduction also covers the gain from the sale of Canadian stocks, as much as $2,000 a year in stock profits is

already tax-exempt). But there is always the chance (however remote) that one day they may make enough that they could benefit a little from a capital gains exemption, and it is this prospect that those who have a major financial interest in such tax subsidies play on.

This crucial factor in the continuation and expansion of the hidden welfare system has been particularly evident during the last few months in the public reaction to proposals for what would undoubtedly be the most expensive, and quite possibly the most ill-conceived, addition to Canada's already out-of-control tax expenditure budget: mortgage interest and property tax deductions.

The recent proposals[17] would place limits on the amounts of mortgage interest and property tax that could be deducted: a maximum of $5,000 a year for mortgage interest and $1,000 for property tax. Only interest and tax on the principal family residence would be allowed. The plan would be phased in over a four-year period.

With more than three out of every five Canadians owning their own home, it is not difficult to understand the initial enthusiasm for such a scheme. As with most tax expenditures, though, its appeal is based much more on appearance than on fact.

In the first place, the 39% of Canadians who are renters, and among whom the poor are disproportionately represented, will receive no benefits at all. While the scheme would turn huge amounts of money over to homeowners, its proponents must assume that renters have no housing affordability problems. At least they must suppose that all renters can become homeowners.

Even if this were a reasonable assumption (which it assuredly is not) and even if all homeowners could take full advantage of the deduction, the distributional consequences would

still be monumentally unfair. Those at the top of the income scale, paying tax at a 62% marginal rate, could get 'housing assistance' of almost $4,000 a year. A middle-income taxpayer with a 30% tax rate would get, at most, only half as much. And all of the poor and near-poor who don't pay income tax wouldn't get one cent in benefits.

The actual distribution of the tax saving from the deduction, moreover, would be even worse than these figures suggest. For one thing, rates of homeownership increase directly with income. Among families and individuals with incomes between $9,000 and $16,000 a year, only about 55% own their own home and so could benefit even in part from the deductions. Among those at the top of the income scale, in contrast, 91% are homeowners[18] and could benefit. Furthermore, many of the homeowners at the low end of the tax-paying range are senior citizens who long ago paid off their mortgages and whose marginal tax rates are so low that their saving from the property tax deduction would be minimal.

American statistics[19] give some indication of how lopsided the over-all distribution of benefits might be. In 1977 the highest-income 16% of American taxpayers received 73% of the savings from that country's mortgage interest deduction, and 79% of the savings from their property tax deduction. And in spite of the expenditure of billions of dollars, the homeownership rate in the United States (which has allowed these deductions for decades) is virtually the same as in Canada.[20]

The undesirable distributional consequences of mortgage interest and property tax deductions would be matched by equally undesirable effects on the price of housing. The deductions would cause many renters, especially middle and upper-income ones, to buy homes so they could take advantage of the new tax provisions. With more people bidding for houses, prices would rise - the exact

opposite of what the scheme is intended to accomplish. It has been estimated that house prices would go up by four to eight percent because of the deductions.[21]

This phenomenon might only be a short-term problem since builders would be encouraged to construct more homes in response to demand, and greater supply should ease the cost pressure. However there would be another long-term problem: Since buyers would be able to pay more for their housing because part of the added cost would be returned through subsequent tax savings, and since persons selling homes obviously would know this, the sellers would charge more. As a result, the average tax saving on the deduction would simply become part of the price of homes, and the benefits of the savings would be neutralized as far as purchasers were concerned. The only winners would be persons who owned their homes at the time the deductions became law. They would get a reduction in their mortgage and property tax payments as long as they continued living in their homes, and would realize substantial capital gains when they decided to sell. (Most or all of the latter, however, would vanish if they were simply selling one house to buy another).

With more people wanting to finance the purchase of homes, mortgage rates would rise. This would be the most visible effect on financial markets, but not the only one. Persons who already own homes but who have less than $5,000 a year in mortgage payments and who want to borrow for a major purchase (say a car) could do so by re-mortgaging their homes and using the money thus obtained to buy the car. In this way the interest on what is really a car loan becomes tax deductible. In the United States this kind of round-about borrowing became so prevalent as a result of their mortgage interest deduction that interest on all consumer loans had to be allowed as a tax deduction - thus driving up total tax spending even further.

And there would be one other cost consequence, this one stemming from the property tax deduction: Municipalities would be less reluctant to raise their property taxes since part of any increase would be offset by the deduction. Thus, property taxes would probably go up, wiping out most or all of the gain from the deduction.

Ironically, it is the U.S. property tax deduction - this supposed form of tax relief - that is often cited as a key factor in the high rate of American property taxes which has led, in turn, to the recent 'taxpayers' revolt'. And the existence of the deduction has also managed to unravel much of the purported gain from the revolt. While California's Proposition 13 reduced the property tax revenues of the state's cities and towns by $7 billion, $2 billion of this total simply flowed into the coffers of the U.S. federal government - the result of the smaller property tax deductions to which the state's taxpayers are now eligible.

Finally there is the price for such deduction schemes. While their advocates have suggested $1.6 billion in lost federal revenues (which would mean $2.3 billion when the effects on provincial revenues are taken into account), this figure has generally been regarded as unrealistically low since it ignores the changes in ownership and financing patterns that the deductions would induce. Experts have suggested that the actual bill could be as large as $4 billion.[22] There is little chance of ever bringing the federal deficit into control with this kind of 'runaway spending'.

## CAN TAX EXPENDITURES BE CONTROLLED?

In a period of mounting deficits, when the government is examining every part of its budget to identify areas where reductions might be possible and when many critics are demanding even further cutbacks, it is nothing other than irresponsible to ignore the billions of dollars which are spent annually through the tax system. The irresponsibility is made all the greater by the alarming rate at which tax expenditures have been growing - a rate that makes the percentage increase in direct expenditures pale by comparison. If Canadians want the federal deficit brought under control, the question that must be answered is: Can tax expenditures be controlled?

It is evident that as long as the government and the opposition not only ignore tax spending but even publicly try to pretend that it doesn't exist, tax expenditures will _never_ be controlled. Perhaps, from time to time, when a subsidy provision is blatantly abused - as, for example, the case of the loophole in Registered Home Ownership Savings Plans which allowed a husband and wife to 'sell' the family home to each other for a tax advantage - steps may be taken to stop the abuse. Such moves are welcome, but they affect only the most minute tip of the iceberg. They do nothing about the underlying problems: the lack of official estimates of the overall cost of tax expenditures, and the absence of any mechanism for reviewing the performance and assessing the continuing need of each tax subsidy.

The illogic of ignoring tax spending has been made particularly clear by events of the past several months. In December, Parliament approved legislation which reduced family allowances to $20 a month and which used the money thus saved - an estimated $690 million - to institute a refundable child tax credit whose

benefits are directed to low and middle-income families. While the National Council of Welfare strongly supports this credit as a significant improvement to the tax system (indeed, the first equitable federal tax expenditure), it is an undeniable fact that the restructured child benefit programs will not reduce government spending by $690 million. The new legislation simply shifts $690 million in spending from one program (family allowances) to another (the child tax credit). However by the current notion of what gets counted as 'spending', total government expenditures will show a $690 million decrease (just as several years ago when Quebec eliminated the dependents' exemption in its provincial income tax and instituted a system of family allowances instead, the province's spending suddenly 'increased' by several millions of dollars).

The same illogical notion of government 'spending' allows a proposal for a $4 billion a year housing program - the most costly federal shelter scheme of all time if it gets implemented - to be passed off as not involving any spending at all. And it equally allows an investment scheme costing fifty or more million dollars a year and giving virtually all of its benefits to the highest-income one percent of taxfilers also to be passed off as not involving any spending.

It is time that the federal government acknowledged the reality of tax spending and published an annual statement of tax expenditures. In the United States, this is already done. Under the Congressional Budget Act of 1974, the President must submit to the Congress an annual estimate of tax expenditures along with his yearly estimate of direct spending.[23] Supplementary data which has been prepared by the U.S. Treasury Department at the request of Congressional committees has even broken down individual tax expenditures by the incomes of their beneficiaries.

The government of Canada owes its citizens no less. And it owes this to them with no delay.

The publication of an annual tax expenditure budget should be accompanied by a plan for the periodic review of all tax subsidies. It may well be that many tax expenditures are justified and should be continued, but this is something which should be determined by a thorough public examination, not left to default. At the least, tax spending in each area of government activity should be referred every year to the committee of the House of Commons which is responsible for comparable direct spending.

Some have gone further and proposed that all tax subsidies be subject to a 'sunset' provision by which tax expenditures would automatically lapse after five years unless they are extended by Parliament.[24] This is a proposal well worth consideration. Many subsidies linger long after they have exhausted their usefulness or purpose simply because they never have to be evaluated or justified. For example, until this year parents of dependent children aged 16 or over were eligible for a higher dependents' exemption than that allowed for younger children - a relic of the days when family allowances stopped at a child's 16th birthday and the government wanted to provide some compensation for families with older children still at school. Allowances for dependent children aged 16 and 17 began in 1964, but it has taken 15 years after its rationale evaporated for the tax expenditure to be eliminated.

An annual tax expenditure budget and a legislative process for reviewing tax subsidies will not, by themselves, control tax spending. But they are absolutely necessary first steps. Unless Canadians want to see an ever-increasing deficit caused by schemes over which Parliament has abdicated all responsibility, they are steps that must be taken.

## FOOTNOTES

1. These are the married or equivalent exemption; the age exemption; the exemption for wholly dependent children; the exemption for other dependents; the deductions for Canada/Quebec Pension Plan contributions, Unemployment Insurance premiums, Registered Retirement Savings Plan contributions, Registered Pension Plan contributions, Registered Home Ownership Savings Plans, tuition fees, child care expenses, medical claims and charitable donations; the interest and dividend deduction; the pension income deduction; the education deduction; the disability deduction; the standard deduction; eligible deductions transferred from spouse; and the dividend tax credit.

2. For the estimating procedure used in this report to calculate the cost of tax subsidies, see National Council of Welfare, Appendix to The Hidden Welfare System (Ottawa: November 1976), pages 19-23. Data on the amounts of exemptions, deductions and credits claimed by taxfilers was obtained from Revenue Canada, Taxation, Taxation Statistics (1976, 1977 and 1978 editions) (Hull: Supply and Services Canada, Printing and Publishing). For other estimates of the cost of tax expenditures in the personal income tax system, see Jonathan R. Kesselman, "Non-Business Deductions and Tax Expenditures in Canada: Aggregates and Distributions" in Canadian Tax Journal, Vol. XXV, No. 2 (March-April 1977), pages 160-179; and Allan M. Maslove, "The Other Side of Public Spending: Tax Expenditures in Canada" (paper prepared for the Conference on Methods and Forums for the Public Evaluation of Government Spending, Carleton University, October 1978). Since Kesselman and Maslove use a different definition of tax expenditure than is used in this report, and since Kesselman's estimates are for 1973 only, direct comparison of their results with ours is somewhat difficult. However applying our estimating technique to the items which they include as tax expenditures yields a 1973 total of $2.425 billion; this is almost precisely the same as Maslove's 1973 total of $2.435 billion and very close to Kesselman's total of $2.235 billion. The same correspondence applies to Maslove's estimates for 1974, 1975 and 1976. It appears reasonable to conclude that the differences in tax expenditure totals among the three studies are almost entirely the product of different definitions of what constitutes a tax expenditure, and that the differences in estimating techniques have only a small effect on the outcome.

3. The estimate of $7.1 billion includes both federal and provincial revenue losses. However, as Maslove points out (op. cit., footnote 13) it would be reasonable to assume that "the federal-

provincial agreements resulting in federal tax point abatement would be altered in the absence of these tax expenditures to maintain aggregate provincial income tax revenues at roughly the same dollar amount."

4. For a comprehensive listing of tax expenditures in the Income Tax Act, see Neil Brooks, "The Tax Expenditure Concept" in Canadian Taxation, Vol. 1, No. 1 (January 1979), pages 31-35.

5. In 1973, for example, the equivalent 20 exemptions, deductions and credit led to a total tax expenditure of $4 billion. David Perry estimates that seven corporation tax expenditures alone in that year totalled $2.4 billion ("Corporation Tax Expenditures" in Canadian Tax Journal, Vol. XXIV, No. 5, pages 528-533).

6. Included among these are the deductions for union and professional dues, other expenses of employment, the general expense allowance, and a number of items which are grouped together in Taxation Statistics under "other deductions".

7. There isn't general agreement whether the tax loss due to the exemptions for spouses and dependents should be included as tax expenditures. Many tax theorists argue that these exemptions are only intended to exclude from taxation a 'subsistence' level of income which varies according to family size; as such, the argument goes, these provisions are part of the basic tax system and not among the special measures that should be called tax expenditures.

   In the United States where the theory of tax expenditures was born, these arguments have some validity. In Canada, however, the situation is far more ambiguous since, unlike the U.S., we have the universal family allowances program which is a direct spending equivalent of the dependents' exemption. If family allowances are included in direct expenditures (and no one would assert they should not be), then the revenue loss due to the dependents' exemption should logically be included as a tax expenditure.

   The inclusion of the revenue loss due to the 'married or equivalent' exemption as a tax expenditure is justified because of the quite arbitrary nature of this exemption. It is permitted for a legally married spouse who does not work outside the home, but denied for a person in precisely the same circumstances who happens not to be legally married. In some cases the exemption is permitted for a dependent child. In all two-parent families it provides a disincentive for a spouse working at home to enter the labor force since the other spouse could lose the tax saving (often appreciable) resulting from the exemption. The

'married or equivalent' exemption has enough of the characteristics of a tax expenditure to be included as one.

8. This group of income security tax expenditures could be expanded to include the education deduction; the deductions for tuition fees, child care expenses and medical claims; and the provisions of the Tax Act which allow certain deductions to be transferred from a spouse. The revenue loss to the federal and provincial governments in 1974 through 1976 due to each of these is shown in the table below. The figures following the 1975 and 1976 totals give the percentage increase in outlays from the preceding year.

| | 1974 | 1975 | | 1976 | |
|---|---|---|---|---|---|
| | [Dollar figures are in millions] | | | | |
| Education Deduction | $ 64 | 64 | 0% | 61 | -4% |
| Tuition Fees | 55 | 51 | -6 | 55 | 7 |
| Child Care | 29 | 36 | 22 | 62 | 73 |
| Medical Claims | 39 | 45 | 15 | 52 | 14 |
| Deductions Transferred from Spouse | -- | -- | -- | 103 | -- |

9. Tax data for 1974 and 1975 combines the amounts claimed under the disability deduction with claims under the age exemption; thus it is not possible to calculate separate tax losses for those years. The 1976 data, however, shows the two amounts separately. In that year, the revenue loss due to the disability deduction came to $10 million, and the age exemption accounted for $304 million.

10. For a further discussion of the consequences of the U.I. deduction, see National Council of Welfare, Bearing the Burden/Sharing the Benefits (Ottawa: March 1978).

11. Another 'incentive' provision of the Income Tax Act is the deduction for charitable donations. As much as 20% of a taxpayer's net income may be deducted under this provision.

Persons who do not itemize charitable donations (or medical expenses) are allowed an optional standard deduction of $100. The resulting tax expenditures are as follows:

| | 1974 | 1975 | | 1976 | |
|---|---|---|---|---|---|
| | [Dollar figures are in millions] | | | | |
| Charitable Donations | $171 | $194 | 13% | $230 | 19% |
| Standard Deduction | 265 | 251 | -5 | 259 | 3 |

12. In 1974-1976 the dividend tax credit operated as follows: Persons with eligible dividends included in their taxable income an amount equal to the dividend plus a 'gross-up' of an additional one-third of the dividend. They were then entitled to a (non-refundable) credit against tax of 20% of the taxable amount of the dividend (i.e., the actual dividend plus the one-third 'gross-up'). Part of the reason for this somewhat complicated formula is that the dividend tax credit is supposedly an attempt to integrate the corporate and personal income tax system.

13. In calculating the tax expenditure for the dividend tax credit, it is necessary to subtract from the amount of credit shown in Taxation Statistics an estimate of the additional tax paid because of the one-third gross-up described in the previous footnote.

14. "Notes for a Speech by Joe Clark, M.P., Leader of the Progressive Conservative Party, to a P.C. Canada Fundraising Dinner at the Hotel Vancouver, Vancouver, B.C." (mimeographed paper), February 15, 1979.

15. Calculated from data in Taxation Statistics (1978 edition), Table 18. Persons with incomes over $40,000 made up 1.1% of all taxfilers in 1976, and realized $196,072,000 of the aggregate of $197,439,000 in net gains or losses on shares in that year - 99.3%. This includes all shares, Canadian and foreign, but there is no reason to assume that the distribution of gains on Canadian shares differs from the total.

16. As shown in Taxation Statistics (1978 edition), Table 18, only 1.5% of all taxfilers in 1976 reported any gains or losses from the sale of shares.

17. Office of the Leader of the Opposition, "Background Paper on P.C. Tax Proposals: Deductability of Mortgage Interest and Municipal Property Taxes" (mimeographed paper), September 21, 1978.

18. Statistics Canada, Income Distributions by Size in Canada, 1976, Catalogue 13-207 Annual (Ottawa: Publishing Centre, Supply and Services Canada; 1978), Table 29.

19. "Tax Expenditures are Calculated by Income Class" in Tax Notes, Vol. VI, No. 11 (March 13, 1978), pages 275-279.

20. For American homeownership rates, see U.S. Department of Housing and Urban Development, HUD Statistical Yearbook (Washington: U.S. Government Printing Office). For Canadian rates, see Statistics Canada, Income Distributions by Size in Canada.

21. Lawrence B. Smith, "Mortgage Interest and Property Tax Deductions: Economic Implications of the Clark Proposal" in Canadian Taxation, Vol. 1, No. 1 (January 1979), pages 38-41.

22. Smith, op. cit., suggests $3 billion in lost federal revenue, to which must be added at least another $1 billion in lost provincial revenues.

23. Office of Management and Budget, "Special Analysis G: Tax Expenditures" in Special Analyses, Budget of the United States Government, 1980 (Washington: U.S. Government Printing Office, 1979), pages 183-211. For a far more comprehensive analysis of tax spending, see Committee on the Budget, United States Senate, Tax Expenditures: Relationship to Spending Programs and Background Material on Individual Provisions (Washington: U.S. Government Printing Office, 1978).

24. See Maslove, op. cit.

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